FT.com
FINANCIAL TIMES

How to stop Ireland's financial contagion

By Wolfgang Münchau
Published: November 21 2010 19:17 | Last updated: November 21 2010 19:17

If you merge 16 small open economies, you get a large closed economy. But here is the catch. If you assemble the leaders of the 16 small open economies, you get a roomful of 16 small-economy politicians. Economic governance through the European Council has proved always cacophonous and often incompetent. It is an institutional framework of finger-pointing. The Irish say they are not Greece. The Portuguese say they are not Irish. The Spanish finance minister said last week that Spain is not Portugal. There are no prizes for guessing what Italy is not.

This governance paradox lies at the heart of the eurozone crisis. It explains, for example, why in the middle of an existential banking crisis, there has been a debate about the Irish corporate tax rate. The French and Germans have argued that Ireland's ultra-low taxes are distorting competition. The Irish say they need a low tax rate to attract foreign direct investment. It is hard to conceive of an issue that is less relevant to the current problem.

The task that needs to be solved now is to stop contagion of the Irish banking crisis. The channels are easy to figure out. The two largest creditors to Ireland are the UK and Germany, with loans outstanding of $149bn and $139bn respectively, according to data from the Bank for International Settlements. An Irish bank default would affect the German and British banking systems directly, and require significant domestic bank bail-outs.

A second channel of contagion would be via the capital markets, to Portugal. The biggest creditor to Portugal is Spain, itself in a precarious position with exposures of $78bn. A default of Irish banks would spread like wildfire. It has to be prevented.

The case for Ireland to take the money from the European Financial Stability Facility (EFSF) is overwhelming. The EFSF was set up precisely for that purpose. Contrary to what I expected, the EFSF has managed to find a way to offer loans with relatively low interest rates. The quid pro quo is a significant lower overall lending ceiling than what the official €440bn ($602bn) headline figure suggests. But even then, it is large enough to handle any conceivable Irish and Portuguese crisis. The EFSF is not large enough to handle any problems that might arise in Spain. In that sense, it is not an umbrella for the eurozone, but only for two of its smallest and most peripheral members.

Considering what is at stake, both for Ireland and the eurozone at large, it is absurd for Dublin to play hard to get. It is equally absurd for others to make an EFSF loan contingent on issues of tax policy. Last week negotiators from the European Union, the European Central Bank and the International Monetary Fund descended on

Dublin for talks that will be difficult. Even as it indicated it would seek a deal on Sunday, the Irish government remained keen to avoid a humiliation. There are also political considerations by those who are guaranteeing the loans. The German parliament, for example, cannot be taken for granted. Also, we should be prepared for elements of structured finance, whose purpose, as ever, will be to obfuscate. Patrick Honohan, the governor of the Irish central bank, already hinted that a contingent standby facility might be all that was needed. Does "standby" not sound so much better than "bail-out"? As long as it stabilises the situation, we should not care.

I expect that the eurozone will get over this particular short-term funding crisis. The mechanisms to solve it are in place. But I am concerned about two medium-term developments, for which they are not prepared – not even close. The first is solvency. The EFSF can provide liquidity for Irish banks, but it cannot make them solvent. Ireland's gross external debt stood at $2,131bn at the end of the second quarter, roughly 1,000 per cent of gross domestic product. As of the end of 2009, the net external debt position was 75.1 per cent of GDP, according to the economist Ricardo Cabral; better than Portugal's, but still high.

To maintain solvency, Ireland and the other peripheral eurozone countries require a return to solid growth very soon. Kevin O'Rourke, professor of economics at Trinity College Dublin, raised an important point of principle last week. If you believe structural reforms are the key for higher growth then surely you cannot apply this argument to Ireland, a textbook example of a country that has implemented reforms. At a time of extreme fiscal tightening, moderate monetary tightening and weak global demand, I fail to see where Ireland will grow. Does Dublin really think foreign corporations would be lured by low corporate tax rates, and choose this moment to invest, given the current uncertainties? And can Ireland really produce a devaluation of sufficient size with sufficient speed to create an export boom at a time like this?

My second concern is the return of large intra-eurozone imbalances. The Organisation for Economic Co-operation and Development last week forecast Germany's current account surplus would be heading back towards 7 per cent of GDP by 2012 – close to the pre-crisis record. We are planting the seeds for the next crisis, for which the EU has no institution, no facility and no task force.

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More columns at www.ft.com/wolfganfmunchau

Comments

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1. Report fringeli | November 22 5:57pm | Permalink

This article is wrong from the very beginning. The default of the irish and the greek etc. cannot be prevented. It already happened. Then let them go bankrupt! Let their creditors go bankrupt. Clean out the system, wipe out the debt! Right now they are paying one credit card off with the other. The germans, the european taxpayer, the irish, the whole world would be better off if these banks/countries went bankrupt. What are the politicians doing bailing out banks and hedge funds at the expense of the taxpayer? Have these people lost their mind?

The FT is very good at giving advices how to spend the taxpayers' hard earned money. Just wanna tell you, these countries that are saving others right now are themselves already spending their creditors' money. It would be their own interest to cut these countries off and try to save themselves. But it won't happen, they will all go down together.

2. Report Eachran | November 22 5:15pm | Permalink

aethias, I agree : the UK would also become stronger as would its financial and professional services sector. The issue is the price : what exchange rate for entry - a bit like traditional M&A.

R, the EURO will not fail because it is principally a political project. Dont forget that currencies are proxies for the societies they represent so that the EURO represents Europe : currencies are nothing in themselves unless we are into fetishism.

My only complaint is that the politicians have messed up again. M. Trichet was correct in trying to tone down the discussions during the seeking of a deal but Mr S would have none of it (probably egged on by Angie and Herr Schauble - bad mistake by Germany unless there are ulterior motives.). If the sea is choppier than it need be then blame Mr Sarkozy.

Incidentally he started this fiasco a few years ago by peremptorily and unilaterally stating that France would stand by its banks, way back during the Northern Rock crisis. This naturally gave The Rep of Ireland all it needed to support its own banks knowing full well that in the EUROzone it is the currency that is always at stake and not the banks. If Europe had acted in concert at the outset then we wouldnt be starting from here (as the Irish countryman might say - topical dont you think?).

On weak countries? France is weak and likely weaker going forward and probably more so than Spain. Easy to fix : change the constitution to make France less centralised and Mr S and his ilk less kingly.

3. Report macfinancialadvisers | November 22 5:03pm | Permalink

Very tricky times for all ahead, the EU will feel this and the credibility of the Euro will be questioned. The UK will definitely feel the full force of Ireland's pain...

4. Report AK | November 22 3:49pm | Permalink

Plagiarism?

Wolfgang Münchau (November 21):
It is an institutional framework of finger-pointing. The Irish say they are not Greece. The Portuguese say they are not Irish. The Spanish finance minister said last week that Spain is not Portugal. There are no prizes for guessing what Italy is not.

Naked Capitalism (November 19):
Some geographical and economic clarifications from politicians, officials and commentators:
1. Spain is not Greece – Elena Salgado, Spanish Finance Minister, ~February, 2010.
2. Portugal is not Greece – The Economist, 22nd April, 2010.
3. Greece is not Ireland – George Papaconstantinou, Greek Finance Minister, 8th November 2010.
4. Spain is neither Ireland nor Portugal – Elena Salgado, Spanish Finance Minister, 16th November, 2010.
5. Neither Spain nor Portugal is Ireland – Angel Gurria, secretary-general of the Organization for Economic Cooperation and Development (OECD), 18th November, 2010.
6. Ireland is not Greece Vanessa Rossi, senior research fellow in international economics at Chatham House in London, 18th November, 2010.
Glad that's straightened out. Still to be determined: whether Belgium is Belgium.

http://www.nakedca...-ring-o-roses.html

5. Report R | November 22 3:49pm | Permalink

I have always thought that there was no way the Euro would fail: too many important people seemed to have far too much (politically, morally, financially etc) invested in it for this to happen.

This afternoon, for the first time, I'm not so sure. After some positive early indications following Irish bail-out announcements, the narrative around the PIGS seems to be negative. It is starting to feel all-too-reminiscent of 2008, when numerous false dawns came and went, while the inexorable remorseless logic of the markets forced financial institutions steadily closer to, and finally over, the edge.

I'm not convinced that Europe's leaders have a firm enough grasp on this situation to fix the problem, or that their domestic political contexts will let them do what's necessary. If they cannot hold the line at

Ireland, and this spreads to Portugal (of which there are already signs), then I do not believe they could stop problems spreading to Spain. As the article notes, it is not clear that there is enough money to bail Spain - and I am not sure that the politics in Germany and elsewhere would permit more to be found for this purpose, let alone the vast sums necessary if Italy looked wobbly too.

6. Report Olaf von Rein | November 22 3:09pm | Permalink

I fear that my suggestion for a corporate tax regime is misunderstood (BRIC-layer et al). If my tax proposal works as intended, then not a single extra cent of tax will follow (so, unfortunately, contribution to the EU budget cannot remain at zero indefinitely), so there is no need for companies to leave Europe. I am merely making a suggestion of how we might distribute income(!) across the EU by means other than periodic default. My aim is to balance incomes and consumption by shifting the means of production geographically closer to the consumer for that part of the production which is consumed within the EU. (For that which is exported outside the EU, fine, let's engage in traditional mercantile warfare and produce that in the cheapest part of Europe.) Yes, perhaps unit-costs may rise in certain parts of the EU as a consequence, but so will incomes. My proposal is about sustainability. BMW, for example, should by now understand that much of the paper profits from its UK hire-purchase operations aren't worth the paper they are written on. Producing in Munich and selling in Swindon can only work for so long...

7. Report jean sliwka | November 22 2:03pm | Permalink

all remain silent about the much bigger fish, Italy, with a shrinking GDP, high debt and high deficit to GDP and an incoherent political environment.

the only survival kit for the eurozone remains an integrated fiscal policy without which a common currency is a delusion.

8. Report BRIC-layer | November 22 1:49pm | Permalink

Olaf von Rein's fiscal ideas are admirable, but I believe them to require a more autarchic structure than is the case with the EU. Companies will leave the EU en masse, to Switzerland and further afield, severely damaging the European economy unless suitable countervailing measures can be found, which, in practical terms, is unlikely.

A more interesting approach is to enable taxation by nationality, as in the US. This would provide a more useful measure for capturing lost revenue, and would be much easier to fine-tune.

9. Report Olaf von Rein | November 22 1:05pm | Permalink

@Bigtail: What is socialist about trying to spread productive assets more widely/evenly across the EU? I do not advocate a change in ownership of these assets, and certainly not to the public hand. I am merely making a recommendation how to resolve the trade imbalances that give will inevitably lead to Irish insolvency. The alternative is periodic (on a generational basis, probably) defaults on financial claims (aka as devaluation in the presence of a floating fx). The problem with that work-out is that it is not just hard on tomorrow's Irish, but also on yesterday's Germans.

As for your assertion that "floating currencies are not devaluing or revaluing, [...] their values will fluctuate over time", well, I am not sure what currency you had in mind? The ITL? GDR? ESP? PTE? You lost me.

10. Report Bigtail | November 22 12:53pm | Permalink

To Olaf von Rein

It seems to me that you want a truly socialist solution to the Eurozone dilemma. Well, unfortunately this will lead to lower growth, higher corruption and - social unrest.

On the subject of devaluation; floating currencies are not devaluing or revaluing, they are floating and hence - their values will fluctuate over time, depending of the state of their economies. If one believes in that humans react to economic incentives, (as I do), fluctuating exchange rates will compensate for many of the mistakes weak humans commit, preventing them from building up huge imbalances.

I suggest you leave the socialist trail and open up for ideas more closely aligned with behavioral economics. Socialism belongs in the dustbin as empirical waste.

11. Report richard.gordon | November 22 12:33pm | Permalink

Wow! This is a scary situation. Incidentally, this article is financial journalism at its very best. It explains an extremely complicated mess clearly and succinctly.

12. Report Olaf von Rein | November 22 12:29pm | Permalink

It never ceases to astonish how in these blogs the solution to all problems in the eurozone periphery is: (1) leave euro; (2) engage in competitive devaluation. This is patently absurd. Not least because so many of these countries joined the euro to put a stop to this game, which over the decades that it went on for never solved the underlying problems of those countries either. I tire of arguing with the proponents of this facile cop-out and would rather comment on a more distant concern:

It seems to me that presently in Europe private claims of eg German companies v Greek companies, are surreptitiously being morphed into public claims of Germany v Greece, Germany v Ireland, ... I worry that before long, all of Europe owes Germany (and perhaps France). This will increasingly incite German public opinion to demand repayment of these loans. The problem is that insistence on repayments would become tantamount for the debtors to a situation Germany herself faced during the Weimar republic, when insistence on reparations by the victors of WWI resulted in social strive. Germany must accept that these claims are false, and that debt-relief is inevitable. If social peace is to prevail across Europe, then it follows that there is no real choice for Europe between being a mere free-trade area of sovereign nations and a political commons with some sort of ambitions/designs on living standards for all members: Germany has demonstrated over the centuries that she will always prevail in a competition between free traders and so, given time, a free-trade Europe will transform itself into a feudal society, with much of the periphery toiling to pay interest to Germany. This is a recipe for social unrest.

I have suggested a solution here before: let Europe implement a corporate taxation regime which takes the LOWEST profits from the operations of a pan-European enterprise in any eurozone country as a baseline, and heavily taxes (consider 100% as an extreme example) profits above that baseline in other eurozone countries. This will put a stop to shifting production into the cheapest parts of Europe and instead encourages more evenly distributed income (and profit) generation.

This simple recipe would, given time, put a stop to intra-eurozone trade surpluses and mountains of German financial claims. It will also put the likes of Ireland and Portugal (and the UK!) back on a sustainable path to solvency. It will also level living standards. This tax could even accrue to Brussels direct, and in that way there may not be a need for EU country contributions for some years to come.

13. Report Bigtail | November 22 10:40am | Permalink

Ive said it before and I reiterate it again;
The curse of fixed exchange rates.

Fixed exchangerates structures radically promotes extreme boom -and -bust cycles.
It happened in Latvia, it is happening in Europe and it is about to happen in China.

The longer the Eurozone waits to let go of the bust countries via devaluation and debtrestructuring, the higher the price. Having said that, there will be a lot of pain no matter what the choice is. This stoploss has been allowed to accumulate way too far.

We have to recognise that there are economic laws governing the world of economics that cannot be tampered away with. One of those is debt/leverage.
It just does not go away by shoveling it under the carpet. It has to be dealt with. Actively.

This means taking stoplosses. Unfortunately for a politician, there will never be an opportune time to take them since they involve pain.

Hopefully, fixed exchangerates for incoherent economies is an idea that will be transferred to the scrapyard. Unfortunately it does not seem it has catched on just yet, as the EU commission is intending to admit Latvia into the Eurozone.

14. Report john d. | November 22 10:09am | Permalink

you mentioned en passant Italy. I believe it will become a huge headache as both its total debt and deficit are on a scale much larger than Portugal, Ireland and even Spain, GDP growth is negative and politically the country is at at a standill.

15. Report BRIC-layer | November 22 9:28am | Permalink

Growth is most likely to return to these countries by a combination of Keynesian measures and devaluation. Otherwise, the social situation can become too fragile.

Neither of these are feasible in the current structure, unfortunately.

16. Report Wolfgang Munchau | November 22 9:12am | Permalink

Please allow to address a couple of points. I am aware that Luxembourg's gross external debt is even higher, and that is why I used both gross and net external debt in my article. Gross external debt is not meaningless, however. It includes the liabilities of foreign owned financial susidiaries, such as those of German banks, and while these are not liabilities of the Irish state, they matter to the rest of the eurozone. My point is not that 1000% gross external debt is large, but that 75% net external debt is large, and that the gross numbers tells me that there is a contagion effect. Portugal's net external debt is over 80%, and gross external debt is 230%. Similar story.
As to the question whether Ireland is insolvent. That depends entirely on your growth assumptions. If you assume that the country reverts to 3% growth, then all will be fine. A decade of zero growth will mean insolvency. I myself find it hard to believe how Ireland can revert to positive growth quickly, given the magnitude of the crisis, and the magnitude of the fiscal adjustment programme. An export boom is needed simply to neutralise the recessionary effects of the domestic adjustment programme. I think the solution to the Irish problem eventually will be a combination of debt restructuring, and a change to the economic growth model - which is too heavily dependent on FDI.

17. Report Erdal Parlar | November 22 8:55am | Permalink

That is the main point which is rised in todays article. Insolvency of some countries which can not have sufficient growth. Nobody will go now to Ireland becuase of 10% less taxes and pay 100% more wage costs then for exemple in Turkey. Greece has no production culture of anything substantial! What will they live on in the future? Turism and feta cheese? What about Portugal and Spain. Where is the growth sector for these countries with euro dependence and high wage costs? What about the yet unexploded housing market in Spain where thousands of mortgae owners have no free value in their homes! I see dark skyes in EU `s future. I recommend a country like Turkey to stay away from this mess!

18. Report pavel.kohout | November 22 8:51am | Permalink

No institutions, no facilities and no task forces can make non-optimal monetary zone optimal. It's not about governance. It's about fundamental divergences across the EMU.

19. Report pavel.kohout | November 22 8:41am | Permalink

Wrong since the very first sentence. Reading the rest is waste of time.

20. Report Lady Economist | November 22 6:41am | Permalink

Exile

really could please list some banks as a example

21. Report Exile | November 22 6:04am | Permalink

Solvency, or rather insolvency, is the driving force. Banks throughout Europe (including, of course, the UK) are insolvent. Markets know this and nothing will now stop the rot. Governments and central banks remain firmly in denial, so the outcome will be disorderly default rather than orderly re-structuring.

22. Report Christopher Scott | November 22 3:16am | Permalink

From an article in the FT on November 2nd:

"But if the former “Celtic tiger” is to get through its current financial difficulties without having to seek outside assistance, it needs a robust economic recovery. In the absence of a fiscal stimulus, this is likely to be driven by the private sector.

It should be well up to the task. The country’s low-tax business model continues to lure foreign multinationals. Several domestic companies now enjoy international scale. The commercial environment has also improved. With price deflation, and business costs falling, Ireland has regained much of its lost competitiveness. The recent strength of sterling is a bonus for Irish companies exporting to the UK."

"According to figures for the first seven months of this year, medical devices exports were up 12 per cent on the same period last year, with shipments of computer equipment up 34 per cent."

Perhaps figures such as these this could be the basis for the devaluation and export boom which you rightly say are necessary? Or would you disagree with this more upbeat assessment by your own paper??

23. Report atheias | November 22 1:00am | Permalink

The solution might be sterling joining the euro ! Everything would become softer, including the euro.

24. Report Jonathan | November 21 11:15pm | Permalink

It was obvious at the Eurozone's conceptual stage that instituting a supranational monetary policy regime without an equivalent fiscal one would be a "half pregnant" endeavour and, hence, doomed to failure. Either the leaders convince the zone's publics to vote in favour of full political union or the Eurozone disintegrates. The EU elite is making similar mistakes to the Depression-era British Treasury and causing mass unemployment. Now, as then, this will result in the rise of extremist political movements.

Are they really so stupid as to risk that just to: 1 save face and 2 prevent their French, German and British banking friends taking a haircut?

25. Report BRIC-layer | November 21 10:17pm | Permalink

Wolfgang, there is no possibility of an resolution to the current impasse without a restructuring. Worse, as the crisis wears on, and tightening starts to bite, we are likely to see some fairly robust and radical political shifts - think of Iceland.

PIIG (plus France? and how about Belgium?) countries all need a devaluation to help them on their way- this is of course impossible within the current Euro structure. Either these countries will have to leave the Euro (increasingly difficult with all the silly alarm bells and panic from van Rompuy, etc. about this killing off the EU), or Germany (and Netherland, Austria, and a few others) will have to fudge a way of setting up a "hard Euro", letting the "soft Euro" countries adjust..

This is going to be difficult- but a clear vision is needed to be able to minimize any collateral damage if it comes to pass.As a sop to Brussels, it would be fascinating to get the UK interested in the possibiity of joining any "soft Euro" (and it would be a wonderful way for Cameron to both neutralize his dissenters as well as put the UK in a position of significant European leadership.

26. Report Why mention Gross External Debt? | November 21 8:45pm | Permalink

I don't see the point of mentioning the Gross External Debt position of Ireland with regards to its solvency. The bulk of this debt is due to the presence of financial services companies operating out of Ireland and thus being treated as Irish Residents. From money market funds & insurance company style wrapped bonds to hedge funds and retail bond funds. This External Debt is offset with External Assets. I.e: Fund XYZ issues 2.2 Trillion Euro's worth of bonds to UK, German and other EU savers in consideration for 2.2 Trillion Euro's worth of cash; Fund XYZ purchases 2.2 Trillion Euro's worth of Bunds, Gilts, Schatz as well as Treasuries and other capital markets securities and assets.

Cleary the size of the financial services industry balance sheet does not have any impact on the structural position of Ireland's banks and balance sheet and the solvency issues going forward for the country and it's banks. These companies are not part of Ireland's balance sheet. If anything they are part of the income statement / revenue side as key inputs to the countries economy.

What this actually points out is that if the EU forces a tax and a regulatory change on Ireland - so that it is less attractive for financial services firms to be based there - then the Irish Economy as a whole will be very impacted by the relocation of these businesses. Irish is and always will be a service led economy focused predominantly on financials services.

As an aside Luxembourg has a nearly identical Euro amount of external debt and a ratio to GDP of 3,854%.

27. Report Lady Economist | November 21 8:34pm | Permalink

If any county bankrupt it is Spain

28. Report Gwilym Rhys-Jones | November 21 7:57pm | Permalink

Cut the crap, Wolfgang. Ireland is bankrupt and so is Portugal and few here in Spain apart from the government think Spain is not bankrupt too.

29. Report Norbert | November 21 7:44pm | Permalink

Will it be possible for Ireland to grow without a devaluation of its currency? The answer appears to be, "No."

A poster named Valuethinker posted this at Morningstar.com:

"The way out of this box for the Irish taxpayer is to suspend the Euro, freeze the banks, devalue and reschedule. Exchange controls like Iceland imposed. That's what Emerging Market countries do under IMF supervision. Because Ireland and Greece are somehow not 'Emerging Markets' they 'cannot' do this. But as Krugman points out, the reasons why leaving the Euro is impossible in terms of bad things (like bank runs) are already happening. So the case is weakening."

Is there a viable alternative?